

ECONOMIC REVIEW
1ST QUARTER 2010

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FYG Planners Pty Ltd ABN 55 094 972 540 Australian Financial Services Licensee No. 224543

2/77 Asling Street Brighton Vic 3186 PO Box 2099 Brighton North Vic 3186
Phone: (03) 9596 2891 Fax: (03) 9596 2899 Email: jdfa@jdfa.com.au Website: www.jdfa.com.au

1. Executive Summary

- The Reserve Bank of Australia is positive and confident about the economic growth prospects for Australia over the medium term.
- The performance of International shares has been weak compared to Australian shares over the past decade. However, in the 1980s and 1990s, the U.S and International stockmarkets outperformed the Australian stockmarket, often by a considerable margin.
- We do not believe that recent weak International stockmarket performance warrants any significant changes to client asset allocations. Past performance is no guarantee of future performance and significant diversification benefits are achieved from including International shares in portfolios.
- The 'correct' amount of exposure to Australian and International shares in a portfolio has no right or wrong answer, but it is a global phenomenon that most investors have a 'home bias' in their investment portfolios.
- Australia's stockmarket is becoming increasingly correlated to Emerging Markets, such as China and India.
- If two comparable investment portfolios have the same average return over a period of time, the one with the smoothest annual returns (or lowest volatility) will always have the higher end value. In this way, diversification can smooth out the volatility of returns by spreading risks, without making a significant impact on the overall result.
- It's important to remember that in boom times, all news is good news. But in bad times, even the best news is discounted. Education and discipline is always essential to an investor having a positive investment experience, regardless of where the economy is in the economic cycle.
- Investors must also remain mindful that they can't rely on the Government to protect them. The Government generally acts after the damage has been done.

If you have any concerns or wish to discuss your financial position or investments, please do not hesitate to contact us.

2. Economic Review

The past decade was not a great one for International shares. The annual performance of the MSCI Index ex-Australia (the best proxy for unhedged International shares) compared to Australia's ASX 300 Accumulation Index over the 10 years to 31 December 2009 was:

Index	Annual Return	Additional Return	Growth of \$1M	Additional Value
ASX 300 Index	8.92%	+12.05%	\$2,350,000	+222%
MSCI Index ex-Aust	-3.13%	-	\$730,000	-

Source: Returns Program for period 1 January 2000 to 31 December 2009

The outlook for economic growth in Australia remains buoyant. The Reserve Bank of Australia (RBA) is particularly optimistic of Australia's prospects, citing the following indicators:

- The current recovery is commencing with less spare capacity than previous ones. Businesses will need to add supply through capital investment over the medium term to support economic growth and avoid inflationary pressures from building up.
- Strong labour demand will increase household income and keep immigration strong, which is presently at its highest levels since the 1960s. Population growth will underpin demand for housing and infrastructure investment.
- Asian countries, which are Australia's major export markets, continue to lead the world in terms of economic growth. Any weakness in North Atlantic countries is not likely to materially impact the Asian recovery as most of the regional expansion is driven by domestic demand rather than exports. For example, the RBA noted that Chinese net exports contributed only 1% of the country's 9% annual growth rate over the past decade.
- Rising demand in Asia should continue to support significant mining investment.

The robust outlook for Australia combined with the recent below average performance of International shares has understandably **led some investors to question whether it is time to reduce their exposure to International shares** and increase exposure to Australian shares and Emerging Markets. Is this a reasonable strategy?

Why invest in the wider world

It is natural that we should want to invest in what we are familiar with. That's why most people's share portfolios mainly comprise companies based in the country in which they live.

A 1997 International Monetary Fund survey of cross border share holdings in 29 countries found that 74% of share portfolios were invested in the domestic market, even though on average each investor's domestic market represented only 5% of the global stockmarket.

There are **some advantages to 'home bias' investing**, such as matching the currency of investment returns with cashflow requirements and possible tax advantages, such as the value attributed to franking credits in Australia. Transaction costs are no longer considered a factor given the range of investment products now available. However, whilst investing at home can have its advantages and make us feel 'comfortable', there are **significant benefits and opportunities from investing overseas** that the investor may be forgoing.

Diversification

Building portfolios with the least amount of risk for a given level of return is the foundation of modern portfolio theory and FYG Planners' investment philosophy. Including international shares in your portfolio helps reduce risk by adding diversification.

International shares are a separate asset class to Australian shares and Emerging Markets, meaning price movements up or down are not strongly correlated. Low correlation provides **diversification benefits, which is the closest thing an investor can get to a 'free lunch'**¹.

Australia's stockmarket is becoming increasingly correlated to emerging Asian markets such as China and India, as they are our major export and import markets. Economic growth in these regions has been to Australia's benefit in recent times, but as the RBA points out, we stand to have a heightened exposure to anything that goes seriously wrong in these countries.

The **Australian stockmarket represents around 3% of the global stockmarket** – we are quite immaterial relative to the global market. There are also many growth industries such as telecommunications, technology, biotechnology and media that represent only a tiny proportion of our economy. Narrowing your investment focus to only Australia eliminates the opportunity to have exposure to countless companies and industries that do not exist in Australia.

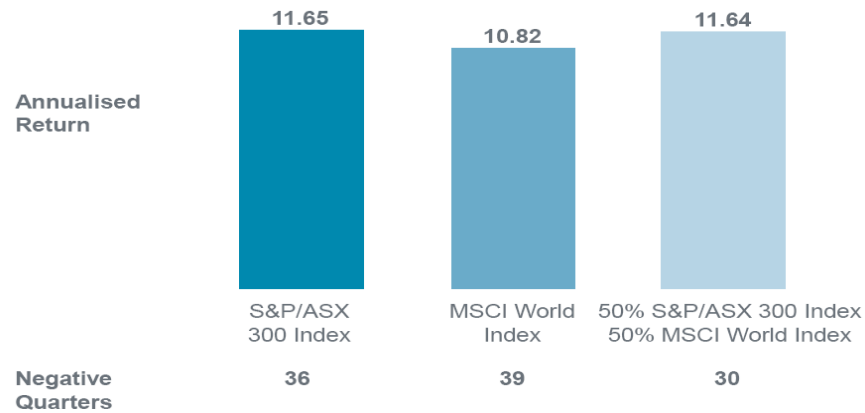
Global diversification can also reduce the high volatility that stockmarkets often experience, which results in higher returns for investors.

As an example, the graph below provides a **simple demonstration of the benefits of global diversification** over the period January 1980 to December 2008. On the far left hand side is **Portfolio A**, made up entirely of Australian shares. It delivered an annualised return of 11.65% and there were 36 quarters in that period when it delivered negative returns.

Portfolio B is made up totally of International shares. It didn't do as well as the Australian portfolio, with an annualised return of 10.82% and more negative quarters, at 39.

¹ Harry Markowitz, Nobel Prize of Economics 1990, University of Chicago

Portfolio C is made up of 50% Australian and 50% International shares. Its annualised return was only slightly less than the Australian-only portfolio, but it had only 30 negative quarters.



If two comparable investment portfolios have the same average return over a period of time, the one with the smoothest annual returns (or lowest volatility) will always have the higher end value. In this way, diversification can smooth out the volatility of returns by spreading risks, without making a significant impact on the overall result.

Past performance is no guarantee of future performance

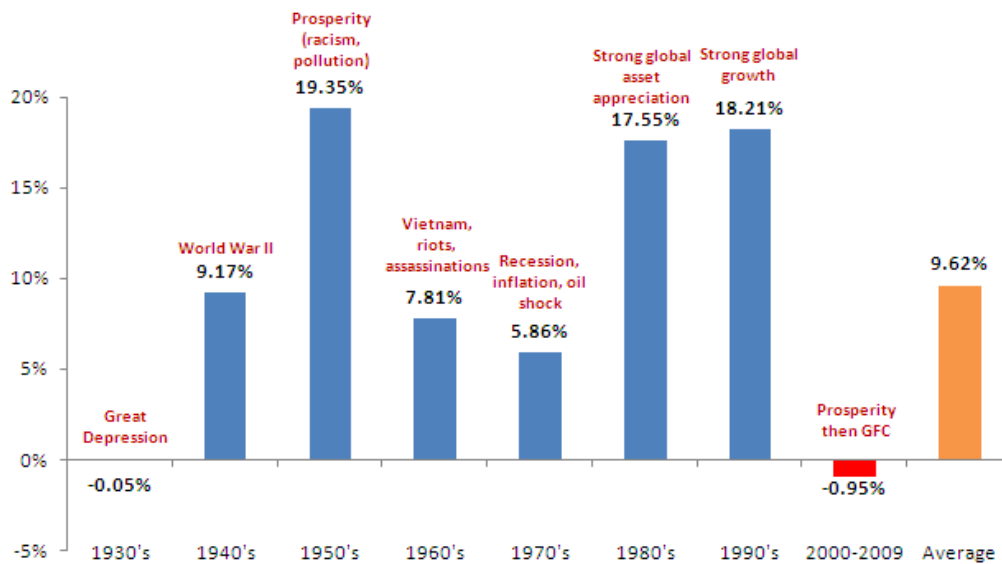
Trying to pick winning countries, just like trying to pick winning stocks, invariably results in investors chasing last year's winner. Many investors don't understand that the market has already made its judgement on the best opportunities by the time they put their money to work.

The table below shows the top and bottom performing stockmarkets in developed countries over the 5 years ending 30 September 2009. As always, there is no clear pattern.

	Year 1	Year 2	Year 3	Year 4	Year 5
Top 3	Austria	Netherlands	Norway	Canada	Hong Kong
	Norway	Belgium	Singapore	Switzerland	Australia
	Canada	Spain	Australia	USA	Sweden
Bottom 3	UK	Hong Kong	Switzerland	Sweden	Norway
	Singapore	USA	Belgium	Austria	USA
	USA	Norway	Japan	Belgium	Austria

Source: MSCI developed market country indices (net dividends) in Australian dollars

Each asset class can experience prolonged periods of above or below average returns. However, returns over the past one, five or even 10 years provide no certainty that similar returns should be expected over the next 10 years. Consider the graph below, representing U.S. returns for each decade since 1930.



Source: Returns Program. S&P 500 performance data is in US dollars to 31 December 2009

Since the 1930s, the US S&P 500 Index has averaged an annual return of 9.62%. Despite all the global upheaval over the past 80 years, including World War II and the inflation fuelled recession of the 1970s, prior to 2000, only the 1930s experienced a decade of negative annualised returns.

In comparison, the past 10 years has been a trying time for investors, with annualised returns of -0.95%. For capitalism to be successful, investors still require a positive rate of return over the longer term as compensation for the risk they accept. **In general, over the past decade, no compensation has been evident for US investors.** As the US represents about 40% of the global stockmarket, Australian investors with International share portfolios have been exposed to these below average returns.

Adopting a tactical asset allocation based on recent performance is fraught with danger, as highlighted in the table below which details the annual performance of the Australian, US and International stockmarkets in each of the past three decades (in Australian dollars).

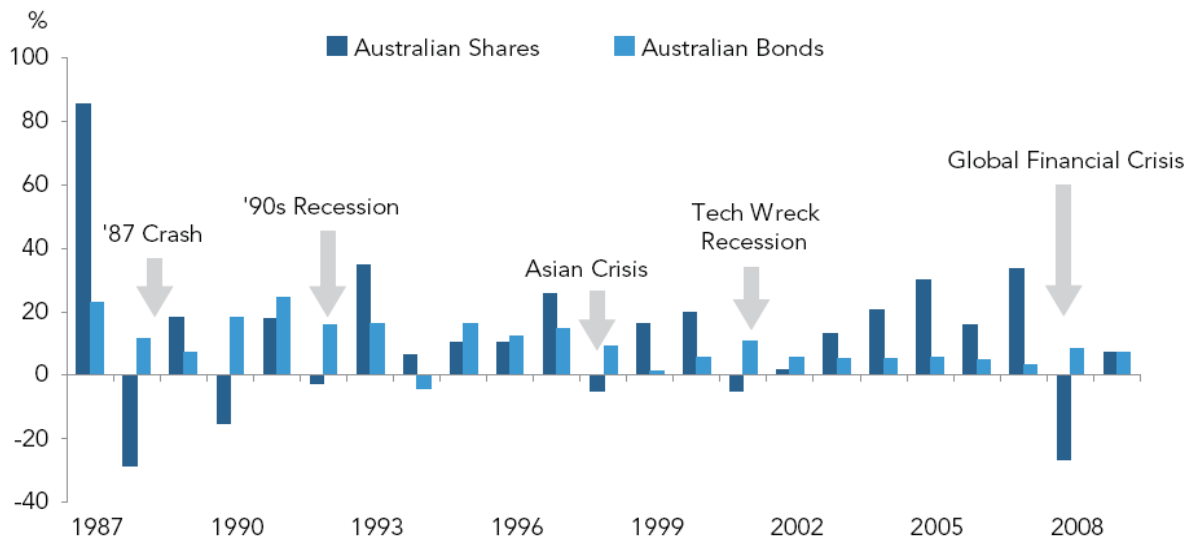
Region	Index	1980s p.a	Annual Variance	1990s p.a	Annual Variance	2000s p.a	Annual Variance
Australia	ASX 300	17.68%	-	10.87%	-	8.92%	-
International	MSCI ex-Aust	24.18%	+6.50%	14.04%	+3.17%	-3.13%	+12.05%
U.S	S&P 500	21.60%	+3.92%	20.35%	+9.48%	-4.01%	+12.93%

Source: Returns Program

In the 1980s and 1990s, the U.S and International stockmarkets outperformed the Australian stockmarket, often by a considerable margin. For example, a portfolio invested entirely in U.S stocks in January 1990 would have been worth 127% more than a portfolio invested entirely in Australian stocks by the end of 1999.

Therefore **in January 2000, investors with significant overexposure to Australian shares may have been considered inappropriate by many.** Indeed, many prominent Australian fund managers significantly increased their exposure to International shares around 2000, a position they maintained throughout most of the decade. However, over the last 10 years, the Australian sharemarket has been one of the stronger performers in the world.

But, as shown above, **the Australian sharemarket doesn't always outperform International shares.** In fact, as the graph below shows, Australian shares don't even always outperform Australian bonds (i.e. fixed interest securities) over short periods of time.



Shares represented by S&P/ASX All Ordinaries Index
 Bonds represented by UBSA Composite Bond Index All Maturities
 Source: Returns program, Oct 1986–Sept 2009

Australia has had a great run over the past 10 years, but whether it will continue to outperform International shares is anyone's guess. Australia's prospects appear strong thanks to our abundant resources, but who can be certain what impact technological innovation and a global emissions trading scheme will have on resource prices over the next 10 years. And if the U.S economy experiences a strong recovery, the performance of its stockmarket could be dazzling.

Even if someone could accurately predict the future and forecast one country's economic growth prospects relative to others, this growth does not necessarily translate into domestic stockmarket outperformance. For example, **around 48% of earnings for US S&P 500 companies are sourced from overseas²**.

The key point is that diversification works whether we like it or not, meaning a properly diversified portfolio is likely to always hold components that have recently performed well—and those that have not. **Diversification deals with uncertainty.** We should learn from past experience not to abandon underperforming asset classes.

How much exposure to International shares should investors have?

If Australia represents only 3% of the global stockmarket, some may question why most Australian investors have the majority of their equity exposure in Australia.

There is no right or wrong answer to this question. When constructing portfolios, we should be mindful that the most important factors are:

² S&P Market Attributes Snapshot, S&P500, July 2009

- Allocation between defensive (i.e. cash and fixed interest) and growth (i.e. property and shares) assets to ensure risk exposure is aligned with the investor's risk preferences, timeframe and objectives; and
- Investment philosophy and framework for making investment decisions adopted.

As detailed previously, investors all around the world have a substantial home bias when investing. We are mindful that **the composition of Australia's stockmarket has become more concentrated in recent times**. Today, financial sector stocks comprise around 40% of the Australian market, and resource and energy stocks a further 30%³. These two groups therefore drive the majority of Australia's stockmarket returns.

Meaningful investment in other important growth sectors, such as information technology (which is 1% of the Australian market but 12% of the global market¹) and healthcare, plus ensuring the benefits of diversification and risk management are present in client portfolios, continues to necessitate global market exposure in share portfolios.

The growing correlation between Australia and Emerging Markets

In our last Economic Review paper we discussed the benefits and risks from including exposure to Emerging Markets in a portfolio.

Emerging Markets are considered a separate asset class to Australian and International shares, and therefore provide diversification benefits to investors. However, in recent times the diversification benefits have slightly diminished.

The table below shows the correlation between the Australian stockmarket and International shares and Emerging Markets over various time periods to 30 November 2009:

Correlation to Australia	5 yrs	10 yrs	15yrs	20 yrs
Emerging Markets	0.815	0.735	0.689	0.594
International Shares	0.623	0.554	0.541	0.498

Source: Returns Program. Australia: ASX 300 Accumulation Index, Emerging Markets: MSCI Emerging Markets Index

Correlation shows the movement in one stockmarket relative to another. For example, if the correlation between Australia and Emerging Markets is 0.594, that means for every \$1 movement in the Australian market up or down, Emerging Markets moves in the same direction but only by \$0.594.

The correlation to International shares remains low, which increases the diversification benefits.

The correlation with Emerging Markets is increasing, reflective of the reliance of Australia's exports (and therefore income) on the economic growth of countries like China and India.

³ 'Point of View', Mark Dutton, AXA CIO, October 2009

We continue to monitor information such as this to ensure the construction of our client portfolios is optimised.

Currency fluctuations

The recent appreciation of the Australian dollar against the currencies of many developed countries reflects the relative strength of our economy, increasing risk appetite of global investors and a rising interest rate environment.

A rising Australian dollar causes the value of unhedged International investments to fall. Since March 2009, the Australian dollar has risen by approximately 30% against major currencies like the Pound Sterling, US dollar and Euro. This has contributed to the recent below average performance of unhedged International shares.

Research has shown that over the long term, hedging share portfolios doesn't reduce risk or enhance returns. But hedging is still a valid strategy if it provides investors with peace of mind through lower short term price volatility.

Performance of FYG Planners International Share Strategies

We are pleased to report that the performance of FYG Planners' (SP) investment philosophy continues to be strong relative to the market. In the table below, we detail the actual performance of our (SP) Global Large, Small and Value strategies compared to their relative benchmark indices over the 9 year period ending 31 December 2009:

SP Strategy	Benchmark Index	Annual Performance			Additional Value
		SP	Index	Variance	
Global Large	MSCI World ex Aust	-3.58%	-3.78%	+0.20%	+2%
Global Small	MSCI World ex Aust Small Cap	2.75%	1.79%	+0.96%	+9%
Global Value	MSCI World ex Aust Value	0.32%	-2.91%	+3.23%	+34%

Source: Returns Program

It is important to remember that this performance is based on a disciplined approach founded on academic research and involves no speculation or forecasting. In comparison, recent reports have shown that around 70% of active forecasting fund managers underperform their relative benchmarks over a 5 year period.

3. Investment Market Review

“The economy’s green shoots have stopped growing....Stocks can’t ignore the economy just yet. The data suggest still more bank losses, more uncertainty about government intervention and a longer recovery process than the consensus expects. ‘We don’t have a business-cycle recovery in sight....You can’t rule out a 2010 recovery, but we have no objective evidence to support it.’ ”

Quotation attributed to Lakshman Acuthan, managing director, Economic Cycle Research Institute. Gongloff, Mark. “Stocks Still Can’t Ignore the Numbers” *Wall Street Journal* March 2, 2009 – **4 days before the stockmarket bottomed**

Three times in just over a decade, the Australian economy has been considered likely to fall into recession, only to prove the doubters wrong: the 1997-98 Asian Crisis (when eight of Australia’s ten largest trading partners went into recession), 2000 (in the wake of the tech bust) and again in the Global Financial Crisis (GFC).

In 2009, the Australian stockmarket had its best year since 1993, with the market rising 38%. The Australian market is currently at similar levels to September 2008, when Lehman Brothers collapsed. However, it must increase a further 40% to return to its previous peak on 1 November 2007.

The best performing ASX sector was (maybe surprisingly) IT, which rose 50.9%⁴. Materials were next best, rising 44.5%. The best performing stock in the ASX 200 was Biota Holdings (up 658%) and the worst performing was Prime Infrastructure (down 99%). There were also some much hyped company floats in 2009, with the two largest – Myer and Kathmandu – finishing the year below their issue prices.

Morningstar Research showed that of the top five performing managed funds in 2009, four of them had still significantly underperformed the market over the past three years. This highlights the importance of not focusing on short term results.

Overseas, the Australian stockmarkets strong performance eclipsed the US (up 20%), Britain (up 22%), Japan (up 19%) and Germany (up 24%), but was not as strong as Hong Kong, which climbed 49%. Note that this performance is in the home currency.

Investors who moved into the perceived safety of cash and fixed interest securities in early 2009 unfortunately locked in the losses they’d incurred by late 2008. None of these defensive asset classes provided returns greater than 4% in 2009. A prominent example of this is the Sydney diocese of the Anglican Church, who saw their investment portfolio shrink from \$200 million to \$44 million by late October 2009. Approximately \$120 million of this loss was attributed to ‘cashing out’ its investments at the bottom of the market.

⁴ Market Review, Australian Financial Review, 1 January 2010

It's important to remember that in boom times, all news is good news. But in bad times, even the best news is discounted. Education and discipline is always essential to an investor having a positive investment experience, regardless of where the economy is in the economic cycle.

Investors must also remain mindful that they can't rely on the Government to protect them. The Government generally acts after the damage has been done.

4. Historical annualised returns of major asset classes to 31 Dec 2009

Asset Class	3 Months	1 Year	5 Years (p.a.)	10 Years (p.a.)
Cash (UBS Bank Bill Index)	0.9%	3.5%	5.9%	5.6%
Australian Fixed Interest (UBS Aust. Comp. Bond Index)	1.0%	1.7%	5.7%	6.5%
Global Fixed Interest (hedged) – Citigroup World Govt Bond Index (1-5 yrs)	0.6%	3.9%	7.1%	7.9%
Australian Shares (S&P/ASX 300 Acc Index)	3.4%	37.6%	8.3%	8.9%
Australian Shares – Large (S&P/ASX 100 Acc Index)	3.2%	36.2%	8.5%	9.1%
Australian Shares – Small (ASX Small Ords Acc Index)	4.9%	57.4%	6.7%	6.2%
Australian Real Estate Trusts (S&P/ASX300 Property Index)	-5.0%	9.6%	-7.5%	4.0%
Global Real Estate Trusts (UBS Global R.E Investor Index)	2.7%	5.3%	-2.5%	7.4%
Global Shares (unhedged) – MSCI World ex-Australia Index	2.3%	0.5%	-0.5%	-3.1%
Global Shares (hedged) – MSCI World ex-Australia Index	4.9%	24.1%	0.8%	-1.6%
Global Value Shares (unhedged) – Value (MSCI World Value Accum. Index)	0.3%	-1.8%	-1.4%	-1.4%
Global Small Shares (unhedged) – Small (MSCI World Small Cap Price Index)	0.9%	11.7%	0.0%	3.1%
Emerging Markets (unhedged) – MSCI Emerging Mkts Index	6.6%	39.0%	12.8%	6.7%
Australian Dollar/US Dollar	1.9%	29.5%	2.9%	3.3%
Inflation*	1.0%	1.3%	2.9%	3.1%

*Underlying rate 3.2% (trimmed mean CPI) for September quarter. December quarter results due 27 January 2010.

Note: Accumulation indices used which assumes reinvestment of dividend income.